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INTEGRATED AUXILIARIES, REGULATIONS AND IMPLICATIONS

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I remember some time ago when the Chairman introduced the late, great Monsignor McGowan in glowing terms. Monsignor got up and in a tone of offended dignity said, "[a]nd you forgot to mention the fact that I also have an application in to be a Notary Public." So much for the over-generous introduction.

Before the Tax Reform Act of 1969 the only significant problem which this office regularly encountered involving the taxation of church-related agencies fell into about two categories: (1) the basic tax status of an institution, and (2) the unrelated character of business conducted by a church organization. Since the Tax Reform Act of 1969, we have been confronted with a myriad of issues which vitally affect the financial status and stability of our institutions. These include an expanded unrelated business income tax, the Pension Reform Act of 1974, the possible loss of tax exemption because of discrimination on ethnic grounds, the rescission of the vow of poverty ruling which has been in effect for 57 years, the definition of the terms "church" and "integrated auxiliaries of a church" with the consequent implications of filing detailed financial returns, and finally, the threat of a loss of tax exemption because of excessive legislative activity or an act of political activity. I make that real sharp distinction, a distinction which we must keep in mind particularly when we have national organizations looking over our shoulder and reporting to IRS.

We have found that many of our people in the field do not understand the distinction, the 501(c)(3) distinction, between legislative activity and political activity. A 501(c)(3) can lose its tax exempt status if it engages in *substantial* legislative activity. There is no such degree, no such qualification for participation in political activity, that is, intervention in a political campaign. Any political activity will subject an institution to the loss of its tax exemption if IRS so elects. And they have so informed us in no uncertain terms.

At the present time IRS officials have informed us that they have completely audited all of the private foundations. Substantial headway has been made in the auditing of the major charitable organizations, in-

cluding hospitals. Also, most of the colleges and universities have been audited. In the next few years there is absolutely no doubt in my mind that the focal point of IRS will be church-related organizations as they are the only ones which have not been audited, the only ones concerning which IRS feels it does not have adequate information. In short, tax legislation and administration which has long been associated exclusively with our economic structure has now developed into an instrument of social and institutional control. One of the most critical aspects of this control mechanism is the attempt by taxing authorities to determine the appropriate function of a church. A classic example of this attitude is reflected in the definition of the term "integrated auxiliary of a church." I had an opportunity to discuss this with you to a certain extent last year. Many things have happened since then, but first I shall briefly touch upon the background and I hope you will pardon me if I repeat some of the same material.

Before 1969 all church-related organizations were exempt from filing Form 990. In 1969, at the last moment, the Ways and Means Committee inserted a provision amending Section 6033 of the Internal Revenue Code, which would have forced all organizations to file; in short, there were no exclusions, no exemptions for a church, no exclusion for integrated auxiliaries. In the Senate we joined with the National Conference of Churches and filed strong testimony, demanding that churches be excluded from Section 6033. Senator Bennett of Utah decided that this was not enough. He agreed that churches should be exempt, but also said we would need more. He introduced legislation providing for the exemption of "auxiliaries of a church." Ultimately that wound up as "integrated auxiliaries of a church."

There was no reference to religious orders in any of the legislative history leading up to the use of the term "churches" and "integrated auxiliaries" in Section 6033. So an effort was made to get a ruling, even better than a ruling, legislative history associating religious orders with the term "church." The conferees examined this and out of it came a very peculiar resolution of the issue. They added one more exemption, "the exclusively religious activity of religious orders," and then, parenthetically, they said: "This shall not include hospitals, charitable organizations, colleges and universities sponsored by a religious order." Now, the legislative history associated with the term "exclusively religious activities of a religious order" is the source of our difficulty.

From 1969 through 1975, as you know, we did not have to file Form 990 precisely because IRS did not define either the term "church" or "integrated auxiliaries of a church" and each year IRS gave us an exemption, an exemption accorded to every church-related organization covered by a group ruling. On February 11, 1976, a Notice of Rulemaking was promulgated. The essence of the Rulemaking was that any organization described in 501(c)(3) whose primary purpose is to carry out the tenets, functions and principles of faith of the church with which it is affiliated would be considered an integrated auxiliary.

Secondly, as another condition, the proposed regulation provided that a 501(c)(3) organization had to have a function or an operation which promoted religious activity among members of the church. So in other words, it was limited exclusively to members of the church. And then in a whole series of examples IRS excluded practically all charitable organizations, including parochial schools. As you know, there was a very severe reaction by all of the church parties. Some 200 protests were made.

A public hearing was held in June of 1976. Approximately fifteen major religious organizations testified. Gene Krasicky testified in our behalf and Bob Barker, who was the attorney for Senator Bennett in 1969, testified in behalf of the Mormons. He certainly knew what the legislative history of the law was because he was closely associated with it. The IRS General Counsel and the various representatives of IRS really whipsawed the speakers. They would say: "Now you say that hospitals and charitable organizations would be exempt but right here in the legislative history of integrated auxiliaries it says that hospitals may not be exempt, it says that colleges and universities may not be exempt, it says that charitable organizations may not be exempt." This quite frankly flustered some of the speakers. But what IRS really did was to take the legislative history of the exemption relating to the exclusively religious activity of religious orders, and equate it with the integrated auxiliary exemption. They suggested that it was the legislative history of the integrated auxiliary exemption, which it never was. It had a distinct legislative history of its own. In fact, the House and Senate had never even had an opportunity to discuss the language in the conference report.

Six months later the final regulation was published on January 4, 1977. The final regulation is in many respects substantially different from the Notice of Rulemaking. And we really didn't have an opportunity to comment on the underlying rationale of the final regulation. We commented on the rationale of the Notice of Rulemaking in February, 1976, but not on the rationale of the current regulation. In other words, there was an abandonment of the Notice of Rulemaking rationale. The final regulation provides that an organization will be considered to be an integrated auxiliary of a church if the principal activity of the organization is exclusively religious, that is, if it applied for an exemption on its own it would qualify for exemption as a religious organization under 501(c)(3). Three tests were set forth to determine this proposition: (1) the organization must have a 501(c)(3) status; (2) it must be affiliated with a church; and (3) it must be organized in such a way that its principal activity is exclusively religious.

Two guidelines were included in the regulation as a means of applying the aforesaid test: (1) if an organization can qualify under any other 501 activity, such as a charity or an educational institution or a literary institution, it is not an exclusively religious organization; (2) if it has a separate legal identity it may not be classified as an integrated auxiliary. Now where these norms came from in terms of the legislative history, I really

don't know. Exclusively religious activity was probably pulled out of the religious order exemption, but there is no basis for the separate legal identity guideline; there is absolutely nothing in the legislative history on this point.

As you know, the organizations which are considered to be integrated auxiliaries include men's and women's organizations that are part of a church structure, seminaries, mission societies, and youth groups. One plus we did get from this. As I indicated, the Notice of Rulemaking provided that parochial schools would not be integrated auxiliaries. They would have to file. IRS divided elementary and secondary schools into two categories. You will not see this in so many words in the regulation but the typical parochial school is now considered to be a component of a church and is exempt under the church umbrella. If you have a school with a separate legal identity like a Jesuit prep school, then the Secretary has exercised his discretion to excuse them from filing. So you do not have to worry about the elementary and secondary school category.

The regulation clearly indicates, on the contrary, that the following organizations are not integrated auxiliaries and must file: hospitals, colleges, universities, orphanages which have a separate identity from a church, and homes for the aged. You will notice when you read the regulation that Example No. 6 provides that an orphanage which has no separate legal identity is associated with the church exclusion.

There has been a very severe reaction from the church groups and it is continuing. Efforts were made at the highest administrative level to get this regulation suspended, but without success. Jim Robinson and I met with the Assistant Commissioner, Mr. Lurie, who addressed us last year. We met with him, Charles Rumph and another gentleman from IRS to see if we could not secure a more realistic interpretation of the term "integrated auxiliary." We did not make significant progress. Based on what they said, all charities must file. When we realized that we were not going to make too much headway in trying to expand the term "integrated auxiliary" we shifted our whole emphasis in an effort to broaden the umbrella of the term "church." For example, we said that we have many staff organizations. Staff organizations fall within two subcategories: administrative and support. With respect to the administrative category we observed that the various agencies of the Church, charities, etc., have traditionally been engaged in coordinating activities and it was agreed that such an organization would come within the umbrella of the term "church." With respect to support organizations, we only gave one example. The example which was given was the Central Purchasing Agency of the Archdiocese of New York. The IRS officials agreed that it would come within the umbrella of the term "church." This then may be considered as an example of a support organization that would be considered exempt.

Finally, we considered the question of the corporation sole. There we made some progress. They were very uncertain about what their position would be with respect to corporations sole, but I gather that they are much

more willing to extend the umbrella of the term "church" to organizations where you have a corporation sole. So if you have a corporation sole, you should keep this in mind.

Regardless of what is done in the next three or four months, some of you are going to have to be confronted with the prospect of filing Form 990. We did do one thing, by the way, when it looked like we were not going to be able to make any progress in expanding the term "integrated auxiliary." We requested a six-month extension of time. The next day I prepared a formal request. We did get an extension of time until August 15 in which to file. The normal filing date for a calendar fiscal year organization would be May 15. If you are on a fiscal year basis which ends June 30 then you will not have to file until November 15. So you do have a little more time in which to make a final determination whether one organization or another organization falls within the category of the definition of the term "church" or the definition of the term "integrated auxiliary." Also, if you make a decision and it ultimately turns out to be the wrong decision, at least the penalty would be cut down. The penalty is \$10 a day for failure to file.

Now, I would like to go over the current Form 990. Unfortunately, I wasn't able to get copies for everybody here but I am just going to read several of the questions as a basis for discussion.

Question 16: "Have you engaged in any activities which have not previously been reported to the Internal Revenue Service? If yes, attach a detailed description." There are many questions like this. This question assumes that you have been filing regularly. Now, just put down "no previous filing, no previous requirement to file." Another question reads: "Have any changes not previously reported to the Internal Revenue Service been made in your governing instrument, (articles)?" Give the same answer to that question.

Question 21: "Enter the amount expended directly or indirectly for political purposes." Organizations which have had to file in the past have really managed to get themselves in trouble by associating legislative activities with political activities, and they put down that they have spent X amount of money on political activity. Automatically, you're called on by IRS when you do that.

Question 18(b): "Is this return filed by an affiliate organization covered by a group exemption letter?" The answer to that for Directory organizations is yes, and you insert the number of our group ruling, which is 0928.

I am just skipping around on some of these. There is a Schedule A that could cause some trouble, particularly for religious organizations. For example, one question reads: "List the officers, directors and trustees." And then there are several blank spaces requesting the extent of compensation. If you have religious on the Board of Trustees, and let us assume there is a contract between the motherhouse and the hospital (about 90% of our hospitals have such a contract), I would state "no compensation" and

indicate that it's covered by a contract between the hospital and the motherhouse. The same thing would be true of the next block, "the compensation of five highest paid employees." You might have a sister administrator and assistant administrator who are receiving very substantial salaries; they might be in the top five.

So again I would say under the compensation block "no compensation" and asterisk "per contract arrangement."

We cannot at this critical time, when the whole vow of poverty is under consideration, do anything that will injure our chances of getting at least a partial revision of 76-323.

There are other sections in here which might cause trouble. There is one which asks whether you're engaged in legislative or political activity "answer yes or no." Well, you know, you can't answer that; you just have to break it down into the two categories. These are just a few of the pitfalls.

Another thing. There is a whole section here which is designed to determine whether there is self-dealing. Now this, as Larry Woodworth told you yesterday, is a major concern of Treasury. They are thinking of applying the self-dealing rules of private foundations to public charities. Maybe not churches. But we still don't know precisely how they're going to treat religious orders. We have this situation, where religious orders either sponsor or control a group of hospitals, and they have the officers of the order, the treasurer general, etc. on the board of trustees of the various institutions, hospitals, colleges, etc., and have financial transactions back and forth. If you answer some of these questions you might get yourself involved in what would ordinarily be considered self-dealing. I think that when answering the questions on that part, a whole series of questions under Part 4, on the sale or exchange of property, the lending of money, the furnishing of goods, or the payment of compensation by and between organizations where there is some identity membership on the two boards of trustees, we are going to have to explain that this part of subsection 3 does not apply to our organizations. It's not a family organization like you would have in a private foundation; it's a unique type of a relationship which must be emphasized in filling out your form, or else you'll get caught up in self-dealing.

And this is not just a theoretical approach. We had this in one of the states. The state had a law something like this, and we had to write briefs and conduct extensive negotiations before we could convince the local tax officials that we were not involved in a breach of fiduciary relationships. So just don't get caught up in that particular answer.

Now, moving on, all the news is not bad. I am very happy with the Notice of Rulemaking that came out on April 8, defining the term "church plan" under the Tax Reform Act. In subparagraph (e) they stated: "For the purpose of this section, the term 'church' includes a religious order or a religious organization (1) if such order or organization is an integral part of a church, (2) is engaged in carrying out the functions of the church, whether as a civil law corporation or otherwise." Now, this language was

not picked out of midair. This language is precisely the language which appears in the Senate Finance Committee Report of 1954. It was the only time that the church was defined. However, IRS in implementing it with a regulation cut down its effect because of the old "sacerdotal" test. We do not have any sacerdotal test in here, we have a good definition.

Father Whelan yesterday referred to this and demonstrated some concern because of the second proposition, "carry out the functions of a church." I would have the same concern, but hopefully we can control that. You notice they did not put any examples in the Notice of Rulemaking. I have already had quite a few contacts from CPA's and attorneys who do not like this particular Notice of Rulemaking, this definition, because they say there are no examples to guide us. Look what they gave us to guide us in the integrated auxiliary bit. So I'd just as soon have this broad definition and make my own decision and work on it on a ruling basis. Our position has to be taken by May 23 in response to the Rulemaking. We will file comments. I don't know precisely what they will be, but I am quite sure that we will support this Rulemaking and encourage IRS to retain it.

Another point that has come up that has caused a little confusion is this. Let us say you have an organization that you feel is not an integrated auxiliary, as it has been currently interpreted, a hospital, university, or some charitable organization. Now, you are going to develop a new pension plan. Is there any relationship between integrated auxiliary and this new Notice of Rulemaking, this proposed regulation for pensions? I have discussed this with IRS officials and was told flatly there is not any necessary relationship. The fact that you are not an integrated auxiliary under that particular regulation would not necessarily preclude your pension from being considered to be a "church plan."

You notice that the term "church" reads *whether incorporated or not*. But we have to be very careful in developing any new pension plan because if you include an organization which is not a church, then you are subject to ERISA. It is as though you made an irrevocable election to come under the Act. So when you are confronted with a situation where you are not quite sure whether an organization which the diocese wishes to cover, is or is not a church, the best advice I can give you is to get an opinion from IRS. An opinion mechanism has been established for rulings of that character. You just cannot take a chance because otherwise you will suddenly find yourself engulfed in all kinds of fiduciary relationship provisions, funding requirements, extensive reporting, etc.

What other developments should we expect? You were told yesterday by Dr. Woodworth that Treasury may impose on public charities legislation which would regulate solicitation. Treasury, quite frankly, is not too happy with the Wilson bill because they wish to regulate the field. They may wish to preempt the field from the federal standpoint, and secure legislation in the nature of licensing regulation. You heard Dr. Woodworth say yesterday that churches and integrated auxiliaries would be exempt. But that, of course, is a matter for further consideration.

Yesterday, Dr. Woodworth said that self-dealing rules may be applied to public charities other than churches. And then the next sentence was that other rules of the private foundations are not under consideration as being applicable to churches and to public charities. So I think what they are probably going to do is to concentrate on a major charitable solicitation bill, and self-dealing.

Now, we are going to have trouble with self-dealing, as stated in some of the remarks I made in connection with Form 990. So we are just going to have to constantly keep on top of this situation, and we will for the simple reason that the field is calling every ten minutes. We like to have those calls. Quite frankly, in many instances if we did not get those calls we would not have the necessary information as to what is really going on in the field, how the District Directors are implementing the legislation, what the CPA's are recommending to our various diocesan attorneys and to counsel representing religious orders. It helps a great deal. It takes a lot of time, but in the long run it gives us an opportunity to present the attitude of the field to Treasury and to IRS. So, don't hesitate to contact us whenever you need to.